Statement of Rt Hon Iain Duncan Smith, Work and Pensions Secretary 27th June 2012

Thank you, Chairmen Davis and Tiberi, Ranking Members Doggett and Neal, and Members of the Subcommittees. It is a pleasure to appear before you today, to share my views on the case for welfare reform in the UK and to offer an overview of the changes I am implementing.

The Government's inheritance

When the Conservative-led Coalition Government entered office in 2010, it faced an enormous problem. A country with a debt burden of 75% of GDP which was set to grow by 16% of GDP over the years to 2013, fuelled by one of the largest current account deficits amongst advanced economies.

Our budget deficit was larger than every economy in Europe with the single exception of Ireland and compared to US gross debt in 2010 of 99% of GDP, expected to grow by 12% of GDP over the same period. The last Labour government had in effect run a debt-based set of public finances, as spending on the public sector rose by 68.3% between 1997 and 2010.

This runaway government spending was a symptom of a wider problem, of a society built on debt and consumption rather than saving and investment. Partially fuelled by some government policies which encouraged spending over saving and hugely assisted by the incredibly easy access to cheap credit, the public borrowed more than ever before. Over the years, we seemed to become addicted to debt.

In the lead-up to the recession, the UK accumulated one of the highest rates of personal debt in the whole of Western Europe: around £1.4 trillion – some 98% of GDP – even before the recession started. That compares to £9.1 trillion in the United States, equivalent to 120% of GDP. Interestingly, in Spain, personal debt stood at around only 83% of GDP.

We embraced a culture of 'live now, pay later' and looked to future generations to pick up the bill. The fact is that debt-fuelled booms feel good while they last, but like all addictions the detox is long and painful.

There were two main reasons why the last Labour Government found themselves in this situation.

The first reason for this economic crisis was that we had become too reliant on financial services. This once great manufacturing nation had given up on the idea of being a world leader in production.

Over the last decade, manufacturing as a share of total output in the UK declined from 14% to 10%. 10 years ago, 1 in 4 jobs in the UK was in manufacturing, today it's less than 1 in 5 – a decline of 6 percentage points as a proportion of the workforce. The UK too easily believed a modern western economy couldn't compete in manufacturing.

However look at Germany. Their record shows that after their labour market reforms in the first decade of the millennium, their productivity rose again. Over the same period, Germany's manufacturing has grown such that it has managed to maintain a much higher 22% share of its economic output. Equally, although the USA experienced a decline in terms of manufacturing as a proportion of the national output, in the last decade the sector grew by some 23% from around $1,500 billion to $1,800 billion.

The second important reason was that the last Government lost control of welfare spending. They sought to micromanage the system and the result was a benefit system of such fiendish complexity that too many chose a life on benefits over work. This was compounded by a lack of conditionality so far too many were able to sit on benefits unchallenged, and was made worse by the pursuit of a poverty target which cost more and more just to stand still. The safety net had become a cage.

The welfare challenge

Take some of the figures we were confronted with when we came into office: 5 million people – some 12% of the working age population – on out of work benefits, 1 million of them stuck there for a decade or more. 1 in every 5 UK households had no one working, and almost 2 million children were growing up in workless families. This was the cultural challenge we faced – entrenched and intergenerational worklessness and welfare dependency.

This problem was not just a product of the recession, as some might have us believe. In the UK, we had over 4 million people – 11% of the working age population – on out of work benefits throughout the years of growth.

Under the previous Government employment rose by some 2.5 million, yet more than half of that was accounted for by foreign nationals. To be clear, this is not a point about immigration, rather the facts serve to remind us that we had a huge challenge with our workforce at home.

Put simply, it was a question of supply and demand. Large numbers were on out of work benefits, yet many were unwilling or unable to take advantage of the job opportunities being created. This is an issue that I understand may have some relevance in the USA too, where according to the OECD, the inactivity rate actually increased by 2 percentage points from 22.6% to 24.6% in the decade between 1998 and 2008.

So what we need to achieve in the coming years is not political and technocratic welfare reform, but internal and external cultural change.

To explain what I mean let me start by taking you back to the early 1940s, when William Beveridge was laying out his vision for the modern welfare state.

A great economist and social reformer, appointed as Under-Secretary in the Ministry of Labour during the war years, Beveridge was driven by a desire to slay the ‘five giants’ that he identified in society at the time: want, disease, ignorance, squalor and idleness.

But he was also clear about the risks that were attached to this laudable cause. He warned that:

> *“The danger of providing benefits, which are both adequate in amount and indefinite in duration, is that men as creatures who adapt themselves to circumstances, may settle down to them.”*

And he was clear that the system should not be allowed to *“stifle incentive, opportunity, or responsibility*”.

In other words, Beveridge was focussed on the kind of culture that the welfare system could underpin. Would it be one that fostered a society where people took responsibility for themselves and their families, and treated welfare as a temporary safety net in times of need, or one that conditioned people to grow dependent on state support, and in turn treat it as a long-term crutch? His fear was that if the balance was wrong it would lead to the creation of a semi-permanent underclass.

Beveridge’s warning went unheeded and our welfare system received little more than a patch-up job, under an incredibly reactive process. A new challenge would emerge in the system and Government would respond by tweaking things, adding new rules, new supplements, even new benefits. But it was all built on a creaking edifice, and the result was a system of monstrous complexity. More than 30 different benefits, complicated by additions within each benefit.

This was then compounded by the fact that when an individual started work part time, they found it impossible to calculate if they would be better off or not. Some of their benefits were withdrawn at 40% as they moved into work, some at 65%, some at 100%; some net, some gross; some only available at 16 hours, some at 24, some at 30.

Feed all of that into a complicated computer system – because no normal person can calculate what it all means for their income – and something extremely damaging happens. People on low wages lose up to 96 pence in every pound they earn as they increase their hours in work. In other words for every extra pound they earn, 4 pence goes in their pocket and the rest goes back to the Government in tax and benefit withdrawals.

So suddenly you have a system that is incomprehensible to those that use it, except for one thing that seems clear – it’s not worth the risk of working.

Debt and consumption

As a result under the last Government, the amount spent on welfare was remarkable, increasing by 40% in real terms even in a decade of unprecedented growth and rising employment. In 2009/10 alone, around £90 billion was paid out in benefit payments to working age people and their families – about the same as the entire education budget. Yet even as money was poured in, scant attention was paid to the results the other end.

Take the example of child poverty, where in the years from 2003/04 to 2010, there was an almost £30 billion increase in welfare spending and £171 billion paid out in tax credits – that's to say benefits for those in work but on a low income. Yet over the same period, there was no actual reduction in child poverty. Labour spent all this just to keep the poverty rate flat.

So too in healthcare, in crime, in education, where Government paid out to manage and maintain social problems, rather than tackling them at their root.

This is a culture marked by an obsession with inputs – with pouring money into social programmes – so that governments are seen to be doing something. Of course big spending is attractive because it brings big media headlines. But my concern is that no one asks what will come out at the other end, in terms of what impact the spending will have on people's lives.

So we are now faced with a fundamental challenge. Levels of social breakdown high and rising; millions of people stuck out of work on benefits; millions not saving nearly enough for their retirement; and politicians – of all hues – addicted to spending levels as a measurement of success, rather than life change as a measurement of success.

These are areas ripe for reform, but how do you reform when there is no money? The answer – you change the way you reform. Not just cheese-slicing, but recalibrating whole systems so that you change behaviours, and change the culture that allowed spending to get out of control in the first place.

This is absolutely critical. When welfare spending balloons, as it has done, the temptation for successive governments has been to squeeze it back down again. But rather like a balloon, when you squeeze it at one end it will tend to grow at the other.

So whilst savings must be made, they must also be sustainable. Otherwise, once the public finances are back in order, and the economy grows again, so the bidding war starts once more. Lobby groups put pressure on government to spend more. Government in turn dip its hands into taxpayer pockets to buy media headlines, and the vicious cycle continues.

Welfare reform

Structural change, leading to cultural change, is the key to this dilemma. In other words you have to tackle the demand itself, changing the effects of welfare by changing the incentives in the system.

My belief is that everyone in the welfare system should be on a journey – it should be taking them somewhere, helping them move from dependence to independence.

So if you are looking for work, the system should make work worthwhile and it should both support and encourage you. If you are a lone parent the system should support you with your caring responsibilities while your child is young, but it should also keep you in touch with the world of work and ensure at the earliest opportunity that you move back to the world of work. What we will not do is put anyone on benefits and then forget about them, as was so frequently the case for those on sickness benefits in the UK.

But if a journey for people is our purpose, we have to recognise that our current welfare system is not fit to provide it. That's why we are reforming it in a way that brings welfare spending back under control, whilst changing lives at the same time.

Universal Credit and the Work Programme

But as we reform, we also have to recognise a simple fact. Not everyone is starting from the same place. There is no point assuming, for example, that everyone understands the intrinsic benefits of work, the feelings of self-worth, or the opportunity to build self-esteem. If you are dealing with someone from a family where no one has ever held work, or no one in their circle of peers has ever held work, there is no point in simply lecturing them about the moral purpose of work.

What you must tackle is the biggest demotivating factor that many people face – the fact that the complexity of the system and the way it is set up creates the clear perception that work simply does not pay.

Thus, after generations in key communities, worklessness has become ingrained into everyday life. The cultural pressure to conform to this lifestyle is enormous, underscored by the easy perception that taking a job is a mug's game. It is this factor which can stop someone's journey back to work in its tracks.

Changing this is what the Universal Credit and the Work Programme are all about.

Universal Credit is a new system we are introducing from next year, which will replace all work-related benefits and tax credits with a single, simple, payment. It will be withdrawn at a single, constant rate, so that people know exactly how much better off they will be for each extra hour they work. This rate will be significantly lower than the current average, meaning that work will pay for everyone, and at each and every hour.

This requires investment up front and we are spending some £2 billion to get it right. But if we do so, and start reaping the effects of cultural change, it will save government huge amounts down the line, as workless households become working households.

But Universal Credit alone is not enough. When you are dealing with people who are a long way from the workplace, who do not have many skills, and do not have the work habit, you need to provide a system that supports them and helps them to get work-ready.

That's what we are doing with the Work Programme, and we have asked some of the best organisations in the private and voluntary sectors to deliver it for us.

They are tasked with getting people back to work, and then helping to keep them there. They are given complete freedom to deliver support, without Government dictating what they must do, through what we call the 'black box'. That means trusting that these organisations are best placed to know what works.

Universal Credit and the Work Programme are two sides of the same coin. Either without the other would not have the same impact, but together they will become formidable tools for taking people on this journey.

Through the two, we are creating a contract with clear obligations. Each unemployed person will understand that we support them to find work and ensure they are better off in work than they are on benefits. In return, they are required to be permanently work ready, attend interviews and try to get work and take work when it is offered. Failure to comply and we take their benefit away – for 3 months the first time, 6 months the second time and 3 years the third time.

The wider reform agenda

More than that, we are capping the total amount an individual can earn whilst on benefits so that even if different benefits add up to more than the cap, they don't get it. Yet this isn't about punishing people, rather it is about removing a major stumbling block as people try to move back to work.

Under the system we inherited, some people with large families on Housing Benefit were living in areas with incredibly high rents. It was actually possible for families to claim over £100,000 a year for help with housing costs in certain cases, and on top of that they received other benefits. Well from next year this will no longer be the case. No matter how the different benefits add up, claimants will not receive more than average earnings.

We are also reforming the culture that allowed people to avoid work by languishing on a sickness benefit for years – almost 1 million for a decade or more.

Large numbers are being checked – of some 130,000 initial outcomes, 37% were found fit for work and some 34% were placed in what we call the ‘work-related activity group’, ready to move back to work when their condition improves. So more than 70% who once would have languished unseen on a sickness benefit, will now be engaged on a journey to independence through work.

We are plotting out a journey in our pensions system as well, except here we are looking to set people on a journey to a decent and sustainable retirement whilst also reducing the pressure on the public purse.

We are pushing ahead with plans to automatically enrol all of those without pension coverage into pension schemes to make saving the norm, and we are making progress with plans to radically simplify the State Pension system – creating a ‘single tier’ pension which is set above the level of the means-test, so that people know that it makes sense to save.

Together with raising the retirement age alongside rising life expectancy which alone will save around £90 billion, these measures are set to deliver enormous savings to the exchequer in due course.

Cultural change

This is not just welfare reform, rather cultural change. The end of the something for nothing entrapment and the renewal of a welfare system that should be seen as a means of temporary support, the beginning of a journey back from dependence to independence.

We are already seeing positive signs that this cultural change is beginning to happen. Though the overall economic outlook is still poor, the jobs figures for the last 3 consecutive months in the UK showed some encouraging signs of stability, particularly stronger than expected growth in jobs from the private sector.

Latest statistics show that even with a big fall in public sector employment, private sector employment was up 205,000 on this quarter. There are now 419,000 more people in work than in there were when this Government came into power in 2010.

What’s more, the total number on out-of-work benefits is down by 80,000 in the same period because of the changes we have introduced to get more people looking for work and into the jobs market. We are reassessing claimants on old incapacity benefits at a rate of 10,000 people a week, and with a further reduction in the age limit for single parents with young children claiming what we call ‘income support’, almost 100,000 lone parents have moved off inactive benefits since 2010.

In this year, we have reduced the economic inactivity level to its lowest since 1992, and we will get welfare inactivity down even further, as our other reforms start to bite.

Just take the changes we are making to cap Housing Benefit. Research published this month shows that of those Housing Benefit claimants affected, a third said they would be looking for a job in future.

This is what I mean by dynamic reform – creating a welfare culture that incentivises work and promotes independence over dependency. In other words, reform that is not just about the benefits system, but about social renewal, part of a wider vision for stable families, with educated children, growing up in areas of low crime.

Government spending

Yet there is one final piece to the puzzle. I have covered what I call external cultural change, change in society at large. But we must also achieve an internal cultural shift, changing the culture of government spending.

It is here that I think we still have much work left to do. We have to reject the old focus on inputs – the old mantra which says that ‘more spending equals good, less spending equals cuts…which equals bad’ – and open up a whole new dimension, one focussed solely on the impact that spending has on people’s lives. That means changing not just how much we spend, but how we spend it.

So let me return to the example of the Government’s Work Programme, where we have been pioneering the use of payment by results. While supporting someone into work obviously has a cost attached, you find that cost is quickly outweighed by the reductions you can make to the welfare bill when you get someone back into work and paying tax. The key point is that we use these future savings to pay for the Work Programme now.

We do that by putting the onus on the 18 Prime Providers who compete to deliver the Work Programme in different parts of the country. They raise the money to deliver the programme alongside their subcontractors; we then pay them when they deliver the results. That means first, getting people back into work. But from day one we’ve been clear that getting people into work on its own isn’t enough. If people do not have ‘the work habit’ – in other words they are not used to the workplace, or convinced that working is right for them – the risk is that they will soon fall out of employment again. So the providers get the biggest payouts when they keep someone in work for 6 months, one year, 18 months, or up to two years in some cases.

Because we are paying for results we will only pay for what works, therefore hugely reducing the risk on the taxpayer, and we make sure that every pound is only being paid out because it has a positive impact on people's lives.

A payment by results system works best when the timescales for success are short and the metrics relatively straightforward. But in addition to Payment by Results there are other areas as well. In particular, we are really trying to open up the social investment market.

I see this as a huge opportunity to get much more private money working in pursuit of the social good. Historically it has been assumed that people could either be 'good citizens' and put their money into charitable works, whilst not expecting anything in return, or they could be 'profit maximisers', who invest their money in commercial ventures and have to forget about the social consequences. Social investment is a way of uniting the two – it is about saying to investors: 'You can use your money to have a positive impact on society, AND you can make a return.'

But to get this investment you need to have programmes that are tested and accredited. That then allows you to create a social bond that people can invest money in.

That is why we have we have agreed to establish an independent foundation that will accredit programmes of work and provide a rigorous assessment of their likely social returns. It's why we're testing a variety of cutting edge programmes through our Innovation Fund, which will help build the evidence base around social investment models, and it's why we have launched Big Society Capital, capitalised with £600 million, and tasked it with the sole mission of growing the social investment market.

This market may still be in its infancy, but I believe it has huge potential. First, it has the potential to greatly increase the amount of funding available for social programmes by bringing in private investment money.

Second, it brings a whole new level of discipline and rigour. Too often in the past good, proven programmes have been introduced by Government but haven't worked.

This isn't necessarily due to a problem with the programme itself, rather it is because as the programme has trickled through the system bits have been added or subtracted, modified and changed, so that in many cases the programme has been neutered.

Why? Because when Government care more about inputs than outcomes it doesn't have much interest in whether the programme actually works. Once it is underway the nature of the programme itself becomes largely irrelevant.

But if the money follows the outcome – as it does with payment by results, or with social investment – we can bring a whole new level of fidelity to the way that civil servants, local authorities, and government at large do social programmes.

It is my personal that if we can truly grow the social investment market it will mark the single biggest change to the culture of spending in Government.

Social renewal

So the prize could be enormous if we get all of this right: cultural reform of society, and of government, in a way that restores effectiveness in public spending, and restores the idea of mobility in our welfare system. In other words restoring the idea that no matter how hard things get for you we will be there with you to help you on an upward path.

But we've got to lock this process in, and as with the process of making savings that I spoke about earlier, it has to be done in a sustainable way or the problems will pop back up again just a few years down the line.

That means we need to change the incentives in the system. In welfare that means understanding that work has to be seen to pay, and people have to know that there is support available for them. In Government, it means making the money follow the outcome.

Through this process, and through the tool of social investment, I believe we can achieve something else as well. We can start to lock those at the top of society back into to our most disadvantaged families and communities at the bottom. We can get our biggest and best business people bringing their time and their skills to some of society's most intractable social problems.

Ironically, perhaps, it has taken difficult times to create a driver for change. When the economy was growing it was just too easy to say 'not now, but later'. For after all, this does involve very tough choices.

But as we try to reshape our economy, and revitalise and refloat the entrepreneurial spirit that has historically characterised the citizens of this global trading nation, we must accept that we will fail unless we can lock all in society to the benefits of this change.

I believe the economies are beginning to show that more manufacturing will return to modern western societies if they have the skills to make it work. Technologies and the best of transport offer a new opportunity to revitalise our countries as manufacturing hubs of sophisticated goods.

None of this will happen unless we reform our societies, so that those now left behind are enabled to play a full part in this future.